

ECONOMIC OUTLOOK

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TAX REFORM AND THE FALLACY OF STATIC REVENUE ANALYSIS

by
Richard W. Rahn

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The American people are overwhelmingly in favor of "tax reform" according to current polls. Why do we want tax reform? Because tax reform could produce a simpler and a more fair tax system, and most importantly, will generate increased economic growth.

Clearly, these are laudable goals, but ones that will be impossible to meet under the current congressional rules for tax reform. Each of the proponents of the various tax reform plans claim their plan is designed to be revenue neutral on a static basis. That is, it will produce the same amount of revenue as the existing tax code in future years, assuming no change in taxpayer behavior.

The problem is however, that by making both the business and personal sides of the tax code revenue neutral on a static basis, there would be as many losers as winners (i.e., for each taxpayer that has his taxes lowered, another taxpayer will have his taxes raised). Realizing the losers will scream louder than the winners, all of the major proposals have provided for an actual tax cut for individuals, and an actual tax increase for business. This is to insure there are more winners than losers.

Now the Catch 22. If you substantially increase business taxes, you will increase the cost of investment. Higher investment costs mean less investment, which means lower employment and productivity growth, and ultimately, lower real economic growth.

The way out of the dilemma is to design the tax reform package so it is revenue neutral on a dynamic rather than a static basis. Properly designed, the additional growth stemming from a more efficient tax system will allow more winners than losers on both the individual and business sides.

The fallacy of static revenue analysis can be understood when it is realized that federal tax increases are discussed as though they were simple additions to revenues, while spending cuts are viewed as simple subtractions from total outlays, much in the same way we approach our own household finances.

For instance, if you have determined that you are spending beyond your means by \$1,000 a year, you have three choices. You could increase your income by that much, perhaps by working more overtime. Or, you could reduce your expenditures by \$1,000, possibly by foregoing a planned vacation or do some of both. Similarly, the federal government, in attempting to trim the budget deficit by \$100 billion a year, could increase its revenues by that much, reduce government spending by \$100 billion, or do both. Unfortunately, at the federal government level, the analogy with our household finances ends.

The difference between a household and the federal government is that any action by the government will have an impact on the overall economy. This, in turn, will affect the federal budget—these are called "feedback effects." When feedback effects are ignored, the impact of a tax increase is estimated by multiplying the change in the effective tax rate the increase would imply, by the level of taxable income anticipated for that year. However, the fact is the change in the tax rate will result in changes in working and spending among households, and in hiring and investing by firms. These economic effects will, in turn, affect total gross national product and taxable incomes, thereby affecting tax revenues.

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Take the following example: assume your taxes are increased by ten percent. What will be your reaction? Your after-tax income will immediately fall by the amount of the tax increase. As a result, you will have to cut back on your expenditures; you may, for instance, decide to postpone buying a new car. Your decision, together with the decision of all other income-earners, will lower total demand for goods and services in the economy. Faced with a lower level demand, firms that supply those goods and services will reduce output. A reduction in output will usually mean that some workers will need to be laid off.

Already we see several economic effects at work as a result of increased taxes. Consumer spending has fallen, production has fallen, total taxable income has fallen and profits have fallen. What does this mean to the federal government? If income and profits are lower, then federal revenues will also be lower. This is true because taxes on individuals are levied on total income, and taxes on corporations are levied on total profits. At the same time, the ranks of the unemployed will swell. This means federal expenditures will be higher since payments for unemployment insurance, and a host of other social insurance programs will rise.

As a result, the impact of a tax rate increase on the federal budget designed to raise \$20 billion in taxes on a static basis will neither increase revenues nor lower the deficit by that much. Rather, the impact on the deficit will be lower than the \$20 billion for two reasons: (1) because the tax base has been reduced, revenues raised will be less than \$20 billion; and (2) outlays for social insurance programs will have risen.

What this shows is that "static" revenue estimates can be very misleading indeed. We know for certain the tax rate increases on the deficit will, in every case, be different from the static estimate. The only way to approximate the actual impact of changes in fiscal policy is to perform a so-called "dynamic" analysis of the particular tax or spending change. A dynamic analysis takes the static estimate one step further—it asks what the impact of the proposed change on the overall economy would be, and how these induced changes in overall economic activity will then affect the federal budget.

In order to approximate the dynamic impact of a fiscal policy option, the static estimates are fed through an econometric model which simulates the workings of the real economy. Such a model is a system of mathematical

equations, based largely on historical relationships which apply to the economy at large.

A properly constructed dynamic econometric analysis will not necessarily give precisely correct tax revenue and deficit figures resulting from tax reform. But, they are certain to be far less incorrect than the static figures.

If we *really* want tax reform, in part, to stimulate economic growth, then it is imperative that Congress and the Administration get away from the "static revenue neutral" charade. Instead, they should focus on how both individual and business taxpayers are apt to alter their behavior as a result of any proposed change.

FORECAST SUMMARY

by

Graciela Testa-Ortiz

Last month's economic news paints a picture of significant strength in the wake of the third quarter's poor performance. The Department of Commerce's revised estimates for fourth quarter real economic activity show that the economy grew by almost five percent, not the 3.9 percent originally estimated (see Trends in Commerce section for details).

Business inventories, which had risen by \$72 billion in the third quarter, increased by only \$35 billion in the fourth, reflecting a much needed inventory correction which has cleared the way for sustained growth in 1985. Total business inventories are expected to increase by \$43 billion in 1985, following a \$58 billion rise in 1984.

Consumer purchases staged a significant comeback during the fourth quarter, rising by almost four percent following a less than one percent increase in the third quarter. The outlook for consumer spending remains encouraging as the financial position of households, in terms of income and employment gains, remains strong. Real personal disposable income, which rose by 3.5 percent in 1983 and an impressive 6.7 percent in 1984, is expected to continue rising at rates close to four percent in 1985 and 1986. The changing characteristics of the American population are playing an important role in overall consumer spending. The strength in home sales that it implies will translate into increased purchases for housing-related consumer durables such as furniture and appliances. The large number of working couples contributes to an increase in the consumption of services. The only negative factor in the consumer picture is the level of consumer indebtedness in relation to income. The debt-to-income ratio rose to 17.6 percent in December, just

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two-tenths of a percentage point behind the 1979 peak of 17.8 percent. However, the data is now under revision and this may shave a percentage point off the ratio.

As we had anticipated, the housing market is showing renewed strength, with starts averaging 1.8 million units and existing home sales reaching three million units in January. In addition to the decline in interest rates, the strong income and employment performance, and positive consumer attitudes, the housing market is being supported by several other factors. Demographics, a major determinant of long-run housing activity, has supported, and will continue to support, a high level of housing starts even in the face of relatively high mortgage interest rates. In 1985, 42 million Americans will be in the 25 to 34 age bracket usually associated with the purchase of a first home. This figure is four million higher than the comparable 1980 number. Furthermore, almost 32 million people will be in the 35 to 44 age group this year, compared to 26 million in 1980. This age group is usually ready to move up to a larger home. As a result, demographic pressures alone are sufficient to support a level of housing starts of between 1.6 and 1.7 million units.

Several other factors play an important role in the demand for housing. Amongst these is an important increase in the supply of credit. Net nonfinancial credit doubled between 1982 and 1984. Further, the decline in outflows of U.S. funds has also increased the amount of loanable funds available to the housing market. The supply of loanable funds also received a significant boost from the deregulation of financial markets which removed the ceiling rates on deposit accounts, thus making it easier for thrift institutions to compete for funds. In the past, when interest rates rose above the statutory limits on deposit rates, savings and loans usually experienced a significant outflow of funds, thus limiting their ability to provide mortgage funds. Finally, the level of building permits authorized is consistent with a future level of starts of about 1.8 million units. Consequently, we expect total housing starts to remain close to the two million mark throughout the remainder of this year.

Sales of new domestic cars averaged 8.8 million units during February, the strongest one-month performance since early 1979. Several other factors, in addition to gains in income and employment, are expected to continue to support the strong performance of the automobile industry. Consumer attitudes regarding automobile purchases are very optimistic, in general, as consumers think now is a good time to buy a car. Also, the average age of cars and trucks now on the road, at 7.4 years, is high, supporting a surge in replacement demand for automobiles. Finally, the lapse of the voluntary quotas on imports of Japanese cars is expected to result in downward pressures on automobile prices as the supply rises. We anticipate total new car sales to remain close to eleven million units this year, compared to 10.4 million last year, and rise to 11.7 million in 1986.

For the first time since the recovery began, total business fixed investment growth averaged below double-digit rates during the fourth quarter. Nonresidential investment rose by 6.3 percent, mainly on the strength of a 19 percent rise in investment in structures. Weakness in new orders during the last months of 1984 were responsible for the poor performance of investment in producers' durable equipment. However, this indicator rose by 3.8 percent in January as new orders for defense capital goods and household durables increased by 12.9 percent and 3.7 percent, respectively. We expect the sector to recover from the fourth quarter lull due to the continuing need to modernize the existing stock of capital. Further, declines in the price of capital relative to labor should stimulate a continuation in the substitution of one factor of production for the other. Finally, uncertainty regarding the impact of tax reform proposals on the rental price of capital is also expected to stimulate nonresidential investment in the near term.

The trade sector will continue to be a net drain on national income in the near term. Although imports of capital goods declined in tandem with the fall-off in investment during the fourth quarter, imports are expected to continue to enjoy a price advantage in domestic markets. In spite of the dollar's strength, U.S. exports rose to a record \$19.4 billion in January. However, a \$29.7 billion rise in imports resulted in a \$10.3 billion deficit on the merchandise trade account.

As has been the case in previous instances of government intervention in foreign exchange markets, the late February intervention cost the Treasuries of the countries involved \$1.5 billion dollars and had no significant impact on the exchange value of the dollar. While it did decline in the days following the intervention, the dollar quickly recovered much of the value lost during that episode. Federal Reserve Chairman Volcker's recent announcement that because of the dollar's strength, the money supply may be allowed to grow slightly faster than would otherwise have been the case, has also caused a slide in the dollar's value early this month. While predicting the dollar's value has become a very difficult endeavor, the available information seem to support a further slight rise in its value during this year. The factors that argue for this strength are as follows: 1) The continued strength of the U.S. economy vis-a-vis the economies of western Europe, and the resulting attractiveness of investments in the United States (see the article that follows for a discussion of current trends in the European economies), and 2) The economic and political stability of the U.S. which renders it a safe haven in a troubled world.

One of the major threats facing the economy during the next two years is the risk that the growing protectionist sentiment in this country may find its way into ill-advised legislation. An import surcharge bill is already being considered on Capitol Hill which, if enacted, would

UNITED STATES ECONOMIC OUTLOOK 1983-1986

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Percent change from previous period at seasonally
adjusted annual rates unless otherwise noted.

	QUARTERS								YEARS			
	Actual		Forecast						Actual		Forecast	
	84:3	84:4	85:1	85:2	85:3	85:4	86:1	86:2	1983	1984	1985	1986
GROSS NATIONAL PRODUCT												
Real GNP	1.6	4.9	4.9	5.1	4.8	4.5	4.9	4.8	3.7	6.9	4.6	4.8
Consumption	0.7	3.6	5.2	3.9	4.0	3.8	4.2	4.5	4.8	5.3	4.0	4.1
Residential Investment	-4.5	-5.2	7.9	9.5	14.0	-2.4	0.8	4.2	41.7	12.2	3.7	4.6
Business Fixed Investment	13.7	6.3	12.6	12.4	11.8	10.8	10.8	10.3	2.5	19.6	11.8	10.8
Equipment	18.6	1.9	14.1	14.3	13.9	12.9	12.4	11.7	7.3	21.3	12.6	12.5
Structures	2.0	18.8	8.6	7.6	6.3	5.3	6.8	6.4	-7.8	15.7	9.6	6.4
Exports	7.7	2.2	8.8	9.4	7.8	6.9	12.6	9.6	-5.6	4.9	6.7	9.1
Imports	55.4	-31.9	12.8	12.3	12.1	9.6	6.1	6.9	7.6	26.5	6.1	8.6
Government Purchases	5.4	6.3	2.3	3.9	3.6	2.8	2.4	2.1	-0.3	3.5	4.8	2.6
Inventory Change (\$B)	71.8	35.3	37.6	40.5	40.7	45.9	43.4	41.9	-13.5	57.9	41.2	44.1
New Car Sales (mil. units)	10.3	10.2	10.9	11.0	11.0	11.2	11.3	11.6	9.2	10.4	11.0	11.7
Housing Starts (mil. units)	1.7	1.6	1.8	1.9	1.8	1.8	1.8	1.9	1.7	1.8	1.8	1.9
EMPLOYMENT, WAGES AND PRICES												
Unemployment Rate (%)	7.5	7.2	7.0	6.9	6.8	6.7	6.5	6.4	9.6	7.5	6.8	6.3
Compensation	3.6	3.3	5.4	3.7	4.0	4.7	6.0	5.3	4.8	4.2	4.1	5.2
Productivity	-1.1	1.5	3.2	3.3	3.3	3.0	2.5	2.5	3.4	2.7	2.5	2.8
Unit Labor Costs	4.9	1.8	2.1	0.4	0.6	1.7	3.3	2.8	1.3	1.5	1.6	2.3
Consumer Prices	3.6	3.9	3.0	3.3	3.3	3.4	3.6	3.9	3.2	4.2	3.4	3.7
GNP Deflator	4.0	2.8	4.1	2.4	2.6	3.1	3.7	3.8	3.8	3.8	3.2	3.5
Prime Interest Rate (%)	13.0	11.8	10.5	10.4	10.3	10.0	10.0	9.8	10.8	12.0	10.3	9.8
Profits from Current Production (\$B)* ..	199.8	209.0	223.0	232.8	237.8	243.4	248.5	255.7	149.4	197.2	234.3	256.1
GOVERNMENT FISCAL POLICY (\$BILLION)**												
Unified Budget—Receipts									601	666	745	810
Unified Budget—Outlays									796	842	955	1010
Unified Budget—Federal Surplus or Deficit									-195	-175	-210	-200

*Corporate profits after tax with inventory valuation and capital consumption adjustments.

**Unified Budget figures on a fiscal year basis.

Source: Modeling and assumptions by U.S. Chamber of Commerce, Forecast Center

FORECAST ASSUMPTIONS

This month's forecast contains the Commerce Department's revised estimates of the national income and product accounts for the fourth quarter of 1984. It continues to take into account all the provisions of previously enacted legislation, including indexation of personal income tax rates. Congress is assumed to pass a deficit reduction package which results in a static reduction in federal government outlays of \$17 billion in calendar year 1986. The money supply, as measured by M(1), is expected to grow by 6.5% in 1985 and 6.9% in 1986. Continued weakness in crude oil prices is expected to result in a reduction in the OPEC marker price to \$26 per barrel in 1986. The federal minimum wage is assumed to remain at \$3.35 an hour throughout the forecast interval. The lackluster performance of the European economies relative to the United States is expected to continue to support the dollar in the near term. The trade weighted exchange value of the dollar is anticipated to rise by 4.8% in 1985. Thereafter, the mounting trade deficit and declining interest rate differential, as well as a strengthening of foreign demand, place downward pressure on the dollar, contributing to a 4.5% devaluation in 1986.

have serious negative implications for the U.S. economy. Studies show that such legislation would have no long-term impact on the current account deficit, which it is intended to resolve. It would, however, likely result in retaliatory measures by our trading partners which will severely restrict our export performance. Indeed, the European Parliament has already passed a resolution calling for retaliation should an import surcharge be imposed on all imports into the United States. The surcharge would also cause a serious inflationary shock on the U.S. economy whose magnitude is a function of foreign exporters' willingness to absorb a part or all of the price increase resulting from the imposition of the tariff. Interest rates would also rise as inflationary expectations rebound. The imposition of further restrictions on trade is a clear recipe for disaster.

As detailed in the previous article and the one that follows, fiscal policy outcomes will also have an impact on the overall outlook. In particular, the failure to address the federal deficit problem through significant reductions in the rate of growth of federal spending could result in tax increases which would depress economic activity.

In sum, our forecast continues to anticipate quarterly rates of real GNP growth in the five percent range during 1985, leading to year over year growth rates of 4.6 percent in 1985 and 4.8 percent next year. Inflation is expected to remain subdued and average 3.4 percent and 3.7 percent respectively, this year and next.

FISCAL BEFUDDLEMENT AND THE FEDERAL BUDGET

by
Ronald D. Utt

Senate Republican efforts to make dramatic progress against deficit spending have apparently bogged down, as many in Congress refuse to accept the kind of cuts needed to pare government spending by \$50 billion or more in the next fiscal year. With deficits projected to exceed \$200 billion per year for the remainder of the decade, the \$50 billion in proposed cuts would be required just to restore the deficit to the level it hit last year. Even more will be required if the target of reducing the deficit to four percent of GNP is to be achieved.

The new budget season got off to a good start in early February when the President presented his FY 1986 budget proposal. It, too, proposed cuts of \$50 billion, but focused its spending restraint proposals on programs other than defense and social security. Counting interest payments on the debt, this left about two-thirds of the budget largely untouched and forced the Administration to make dramatic cuts in the remaining one-third in order

to achieve the needed \$50 billion in reductions. Included in the proposal was a five percent pay cut for all federal civilian workers and termination of nearly twenty five programs, including general revenue sharing, Export-Import Bank loans, the Small Business Administration, AMTRAK, and Urban Development Action Grants. Many other programs were to be continued but at a greatly reduced level. Howls of pain and suffering were heard throughout the land as one constituency after another had its ox gored and served up as shish kebab to the cause of deficit reduction.

In contemplating the likely constituent reactions to such a proposal, Congress couldn't help but conjure up images of Little Bighorn, the Alamo and other lost causes in which there were no survivors. Unlike Custer and Crockett, however, members of Congress possess acute survival instincts. Fearing the emergence of a no prisoners policy among their constituents, some went to work on alternative approaches consistent with their long-term career goals, while others took the ox by the horns and tried to craft a package that achieved dramatic cuts in every area of spending. The first to hit the chopping block was Mr. Weinberger's defense budget. The Department of Defense wanted a \$32 billion spending increase—an eleven percent gain over this year's spending level. Inasmuch as defense spending has doubled since 1980, many in Congress figured that we could easily afford a one-year pause in the build up and recommended a freeze in defense budget authority. A one-year budget authority freeze would save somewhere between \$15 and \$20 billion dollars in 1986 and approximately the same amount in subsequent years as future defense budgets resumed growth from a lower base.

The next sacred cow to be dragged up to the altar was social security and its system of automatic cost of living adjustments (COLAs). Although the President made a firm promise during the campaign not to make any cuts in the program, many in Congress were not so encumbered and began to look closely to see how much could be saved through a one-year COLA freeze. Plenty, as it turned out. Savings would amount to about \$7 billion in 1986 and almost \$10 billion in each of the subsequent years. While the elderly squealed at the prospect of losing their automatic increase for one year, and their representatives in Washington commissioned a study to quantify the suffering this would cause, these members persisted in keeping the COLA freeze on the front burner, so to speak. Perhaps this reflects the growing realization that the elderly are no longer the impoverished group that folklore suggests. Indeed, recent reports from the Census Bureau indicate that our typical elderly citizen is better off than the rest of us. The incidence of poverty amongst those over 65 years of age is about one-third that of the population as a whole after taking into account all benefits going to the elderly, and the after-tax, per-capita income of those over 65 is \$335 higher than that for the population as a whole.

By adding the changes in Defense and Social Security to their prospective budget, the Senators achieved an additional \$16 billion in savings to apply against the FY 1986 deficit. Alternatively, this amount could be used to soften the President's proposed cuts and still reach the \$50 billion target. Or, at least, that is what the plan, as developed by Senators Dole and Domenici, envisioned. But "Twixt cup and lip..." as the proverb observes; momentum was lost as members of Congress struggled to maintain funding for preferred programs, which seemed to include virtually everything now in the budget. The ambitious schedule that was established—a full-blown proposal by the end of February with Senate Republican backing, followed by a vote of the full Senate in late March—went with the wind, and staffers close to the process have no guess as to when we will see a budget and what will be in it. Meanwhile, in the House of Representatives, members have temporarily retired from worrisome budget deliberations, deciding instead to watch how things play out in the Senate.

And so the struggle goes on and the fiscal imbalance worsens. In late February, the U.S. Treasury released budget figures for the first four months of the 1985 fiscal year. It paints a grim picture of the failure to come to grips with deficit spending and illustrates how runaway spending is driving the deficit higher and higher. So far this fiscal year, the deficit is running \$10 billion above last year's level, propelled upward by a 12.4 percent increase in spending. This is more than twice as fast as spending grew in the last fiscal year, three times the rate of inflation and a third faster than the economy's growth rate. As a result, federal spending is expected to rise to a 24.5 percent share of our gross national product, the second highest peacetime share on record and just 0.2 percentage points less than the all-time record set in 1983.

The culprits involved in this orgy of spending are easy to find. Outlays for agriculture are up 27 percent from last year, propelled forward by a 50 percent increase in the cost of commodity price supports. Interest on the debt runs a close second with an increase of 22 percent, largely as a consequence of the massive debt accumulation over the past five years. Medicare spending zips along at a 12 percent growth rate, even though the eligible population has increased by only 1.4 percent, while the Environmental Protection Agency is spending at a rate 16.8 percent faster than last year. In all fairness, many programs are reduced from last year's levels, but these cuts did not offset the large increases elsewhere.

The Administration's budget proposal makes a compelling case for the many cuts and terminations it proposes. In proposing to terminate the AMTRAK subsidy, which would save \$2.2 billion over the next three years, the OMB notes that the system handles only two percent of the intercity passengers at an average subsidy of \$35 per rider. On three routes—New York/Boston, Chicago/New

York, and Portland/Seattle—the subsidy is so large that it would be less costly for the government to end the train service and pay the full price of bus or plane fare for each and every AMTRAK passenger on these routes.

Revenue sharing, a program to transfer funds from federal to state and local governments, is also proposed for termination at a savings of \$4.5 billion a year. It was originally started at a time when the Feds had a projected surplus of funds while the state and local governments were strapped for money. That situation has changed. Last year, when the federal government ran a deficit of \$175 billion, state and local governments ran a surplus of \$52 billion.

Spending on agriculture, mostly price supports, continues to soar out of control. In spite of, or more likely, because of, fifty years of intense and expensive involvement by the federal government, parts of our farm sector are confronting severe economic stress. Falling incomes at the less efficient farms have made it impossible for these farmers to maintain their debt service obligations. Some have been forced into bankruptcy while others are insolvent and likely to follow suit. Despite \$16 billion of federal farm assistance last year and another \$21 billion in 1985, the situation has only worsened. Expressed another way, each American household has to cough up an extra \$247 in taxes this year to subsidize agriculture. This, of course, does not include the cost of higher food prices created by the commodity price support system and the effect this has on government food stamp costs.

Recognizing that fundamental reform is needed if this problem is to be solved once and for all, the Administration has proposed a bold plan that would restructure and strengthen our agriculture economy while saving the taxpayers a bundle in the process. Under the President's plan, spending for agriculture would be reduced by \$27 billion over the next three years in a market-oriented restructuring of the commodity price support program.

Congress, however, seems likely to reject this approach and is now in the process of enacting legislation that will *increase* federal farm spending. This month, the Senate and House of Representatives passed a farm credit bailout bill that will add about \$7.4 billion to this year's deficit. Assuming that they also reject the President's proposed farm program reforms, which the Senate Budget Committee has already done, 25 percent of the savings in the President's deficit reduction package will be lost.

And so it goes as the lines of battle are drawn over each and every proposed spending cut. Almost \$12.8 billion of potential savings could be lost in agriculture. More than \$4 billion could be lost if cuts in revenue sharing are rejected. At this point, the \$50 billion in savings has been

whittled down to \$33.2 billion by the preservation of just two programs. Fearful of angering the elderly, Congress might also reject the \$4 billion savings proposed for Medicare and the three-quarters of a billion in cuts for civil service retirement. Now the savings are reduced to \$28 billion, and falling as more and more programs are held harmless. And so it goes.

As of early March, Senator Domenici is struggling to put together a package of budget cuts totalling \$64 billion, the amount needed to bring the 1986 deficit down to four percent of gross national product. So far, constituent pressures are ripping the package apart and he is unable to get even his Republican colleagues behind the effort.

If the Senator fails, events will likely move in one of three directions: One, most budget cuts will be in defense, thereby jeopardizing our national security without making much progress against future deficits; two, Congress might try to pass a big tax increase, thereby jeopardizing our economic growth potential for the rest of the decade; finally, Congress might try a combination of the two, leaving us with the worst of both worlds—a kind of Jimmy Carter Redux; and we all remember how much fun that was. These are the risks we confront if Senators Domenici and Dole fail in their efforts to enact a comprehensive program of substantial reductions in spending.

EUROPESSIMISM: FACTORS UNDERLYING WESTERN EUROPE'S ECONOMIC DECLINE

by
Graciela Testa-Ortiz

One of the characteristics of current global economic conditions is the lack of synchronization among the recovering economies; in particular, the extent of the lag between the recovery of the Western European nations and that of the United States and Japan. During the first year of recovery (1983), the only European nation to experience a rate of economic growth comparable to that of the United States was the United Kingdom. West Germany, long seen as the engine for European growth, achieved a rise in real gross domestic product (GDP) of only 1.3 percent that year. The French and Italian economies weakened in the face of fresh austerity measures, which in the case of France were necessitated by the Socialist excesses of 1980-81.

The performance in 1984 was even more disheartening. The United Kingdom and West Germany saw growth rates of only two percent and 2.5 percent, respectively, as domestic labor unrest contributed to significant production losses. Italy put in the best performance of the lot, growing by three percent. And France came in at only 1.8 percent. With the exception of the United Kingdom, the outlook for this year is generally considered optimistic. Unfortunately, this optimism translates into rates of growth for the four major economies which range between two and three percent—not very encouraging prospects, particularly when compared to the expected performance of the United States, Japan, and the East Asian and Pacific Basin nations (see Table 1).

TABLE 1
REAL ECONOMIC GROWTH, 1982-1986
(percent change)

	Actual			Forecast	
	1982	1983	1984	1985	1986
West Germany	-1.1	1.3	2.5	2.7	2.8
France	2.0	0.7	1.8	2.0	2.0
Italy	-0.4	-1.2	2.9	2.7	2.0
United Kingdom	2.5	3.2	2.0	2.9	2.8
Smaller European Countries	0.8	1.6	2.5	2.5	NA
United States	-2.1	3.7	6.8	4.6	5.1
Canada	-4.4	3.3	4.8	2.5	2.9
Japan	3.3	3.0	5.8	4.6	3.6
East Asia ¹	NA	6.8	5.8	4.2	4.6
Australia	0.7	0.6	6.1	2.8	2.2
Latin America ²	NA	-2.6	1.8	1.9	2.9
Africa ³	NA	-0.6	-0.8	2.2	3.4
Middle East ⁴	NA	-10.1	0.6	6.0	7.6

¹Hong Kong, Indonesia, Korea, Malaysia, Philippines, Singapore, Taiwan, Thailand.

²Argentina, Brazil, Chile, Colombia, Ecuador, Mexico, Peru, Venezuela.

³Algeria, Morocco, Nigeria, South Africa.

⁴Egypt, Iraq, Kuwait, Saudi Arabia.

Source: Organization for Economic Cooperation and Development, Data Resources, Inc., The Economist Intelligence Unit.

Until recently, domestic demand has not provided any support to the European economies. The meager growth that they have experienced thus far is derived from the strength of foreign demand, which in the case of West Germany, for instance, accounts for as much as thirty percent of domestic production. British exports to the United States rose by 17 percent in 1984, while German and French exports to this country increased by about 35 percent. This rise in exports to the United States is more strongly related to the strength of U.S. demand, than to the appreciation of the dollar.

In spite of the surge in exports, it appears that some European nations have been unable to benefit from the slide in the exchange rate of their currencies against the dollar and the price advantage that it should provide. For instance, between 1981 and 1983, sterling declined 39 percent against the dollar and almost 19 percent against other major currencies. Nevertheless, British exports rose by only 19 percent, while imports increased by 30 percent. A survey by the Confederation of British Industry shows that while exports of unique products and luxuries, such as Jaguar cars and Wedgwood china, are booming, traditional exports are doing rather poorly. Reflecting this, Britain's share of world exports has declined from ten percent in 1975-81 to 8.5 percent in 1981 and 7.9 percent in 1983. France faces a similar problem. The balance of trade gap was reduced by one-quarter between 1982 and 1984; however, this was achieved by a boost from strong sales of cereals, Airbus contracts and Arab orders for French weapons. Traditional manufacturing exports, on the other hand, remain weak. Italy has also suffered from an imbalance in its exports resulting from the foreign exchange performance of the lira. While the lira continues to fall against the dollar, it has remained strong against most other European currencies. When combined with the high costs of production in this nation, the result is that Italian exports to the U.S. have done reasonably well, but its trade deficit with the EEC has risen.

Changes in the sterling exchange rate should have served as a stronger stimulus to British exports. A recent OECD (Organization for Economic Cooperation and Development) study concludes that the reason for the lack-luster performance relates to comparatively high labor costs in Great Britain. For instance, in the year to November, manufacturing wages were rising by 8.5 percent, placing Great Britain at a cost disadvantage relative to other exporters. Labor costs in West Germany, France, and Italy, on the other hand, have remained relatively stable, and, as in the United States, have made a major contribution to the moderate rates of inflation now being experienced. In France, wage increases fell below price increases in 1984 after rising by eleven percent in 1983. The inflation rate has declined from 13.3 percent in 1981 to 6.7 percent last year, the lowest inflation rate in twelve years. Nevertheless, both wages and prices in France are still rising faster than the OECD average, even though France has been successful in reducing wage indexation. Italy, on the other hand, continues to labor under the scala mobile (a system of indexing wage scales to inflation), although it is becoming increasingly apparent that it must be changed.

With the exception of Italy, domestic demand in Europe, particularly in the consumer sector, remains weak. A turnaround is now apparent in the investment sector, which began to perk up as business confidence improved. However, recent increases in interest rates in Great Britain and West Germany, which were geared

towards supporting domestic currencies, may very well dampen the strength of this sector in those countries. In the U.K., the clearing banks' base rate rose from 9.5 to 10.5 percent on January 11th, and then again to 12 percent three days later. West Germany raised the Lombard rate 50 basis points to six percent. France and Italy, on the other hand, have actually reduced interest rates. In France the base lending rate was reduced by 50 basis points to 11.5 percent in January.

Unemployment remains Europe's intractable problem. With economic growth projected at moderate rates, these nations will be unable to stem the upward drift in joblessness. The numbers surrounding the employment situation mirror Europe's structural problems. Approximately one out of ten Europeans is currently unemployed. In Britain, the unemployment rate reached 13 percent in January, and the situation in some of the smaller European nations is even more dismal. While the unemployment rate in France averaged 9.3 percent in 1984, below the U.K. and Italy, it rose to 13.6 percent in January 1985, and is rising faster than in other OECD nations. In Spain, the official jobless rate reached 20 percent last year. What is even more disheartening is the trend towards long-term unemployment. In Britain, 40 percent of those unemployed have been out of work for more than a year. Some of the measures enacted to reduce unemployment have done more harm than good. France, for instance, opted to reduce the work week and lengthen holiday periods. This has increased labor costs but has had no visible impact on the employment situation.

TABLE 2
COMPARATIVE UNEMPLOYMENT RATES
(percent)

	Actual				Forecast	
	1970s Average	1982	1983	1984	1985	1986
West Germany	2.3	6.7	8.2	8.4	8.4	8.4
France	3.7	8.0	8.2	9.3	10.5	11.0
Italy	6.3	9.1	9.7	10.0	10.5	10.8
United Kingdom	4.7	11.0	11.5	11.8	11.8	11.8
Smaller European Countries	NA	10.7	12.2	12.8	13.3	NA
United States	6.1	9.7	9.6	7.5	6.8	6.2
Canada	6.6	11.1	11.9	11.5	11.5	11.5
Japan	1.7	2.4	2.6	2.8	2.5	2.5

Source: Organization for Economic Cooperation and Development.

Why is the European economy stagnating? Why has it been unable to create jobs? What is the explanation for Western Europe's unaccustomed status as the world's laggard?

Bad Policy is One Reason

The role that the public sector plays in the European economy offers one explanation for its current stagnation. Europeans have increasingly looked to the state to provide basic services which are best left to the marketplace. As a result, the tax burden in Europe is significantly higher than in the U.S. or Japan. During 1982, taxation averaged 44 percent of gross domestic product in West Germany, France, Italy and Great Britain. Although many attempts have been made to increase incentives through reductions in tax rates, these reductions have generally been nullified by indirect tax increases, such as levies on gasoline.

These revenues help to support a bloated public sector which accounted for an astounding 46 percent of GDP in 1982. A large proportion of the region's public spending is in the form of social programs such as jobless compensation, which in their generosity, may well contribute to extending the length of unemployment. Between 65 and 95 percent of the previous wages of the unemployed are currently being paid by the state, effectively removing the urgency of searching for alternative employment that the jobless population should feel. Indeed, this is one of the greatest criticisms of the British benefits system. For instance, some benefits are higher for families with children, while wages, of course, make no distinction as to family size. A step in the right direction was taken in 1981 when unemployment benefits became taxable. However, an important disincentive remains in the form of the supplementary benefit used to raise the income of the working poor. Once the income of a person receiving supplementary benefits reaches a certain level, the benefits are removed on a pound for pound basis. This is the equivalent of a marginal tax rate of one hundred percent.

The social security system adds an incredible burden to businesses everywhere in Europe and further raises the cost of hiring additional workers. In Spain, for instance, social security payroll taxes amount to 30 percent; however, the employees' share of the total tax burden is 13 percent, while the employer pays the remaining 87 percent.

A host of labor regulations throughout Europe inhibit labor mobility. It is virtually impossible to fire anyone, even for economic reasons. To do so, a company has to obtain government approval, a lengthy process at best. They may also be faced with industrial tribunals or expensive unemployment compensation payments. Minimum wage legislation and other restrictions on wage flexibility also exist. In the effort to provide job security, one basic factor of economic life has been lost; namely, an innovative firm must be able to hire and fire workers quickly as demand patterns change. As a result, firms are reluctant to hire new workers when demand rises, since it would be extremely difficult to lay off these workers in times of slackening demand.

Bankruptcy laws are similarly restrictive; bankruptcy is still looked upon as a moral weakness. However, a relatively large number of bankruptcies, even in periods of economic recovery, reflects the workings of a competitive economy and a developed venture capital market that allows for a host of different products and ideas to be tested. Many of the new companies die off fast, but the survivors grow into large firms just as rapidly. The ability of firms to enter and exit the market is a major characteristic of a strong market economy.

The Uncommon European Market

The European Economic Community (EEC) was created 27 years ago to provide the member nations with an integrated market whose size, with a population of 350 million people, would rival the U.S. market. Unfortunately, it has yet to reach its objective of serving as a stimulus to European unity and progress. Moreover, at times it seems hobbled by nationalistic self-interest. The Community has become a caricature of itself: an uncommon market perpetually embroiled in bickering over agricultural issues and absurd discussions. Witness, for instance, the recent debate over whether or not to require that all dogs and cats in the member countries have identification numbers tattooed on their ears.

One of the most persistent problems within the Community, one which it was established to solve, is the immobility of resources—labor and capital—across national frontiers. For instance, a truck driver going from West Germany to Italy has to fill out 27 forms to get through customs. In fact, it is estimated that border delays cost Europe \$10 billion a year.

The lack of standardization is also rampant. It affects everything, from telecommunications to university degrees. For instance, telecommunications equipment makers can only look to their home market, not to the European market, as a source of demand because of different standards across countries. National favoritism has many faces. One manifestation of this is that virtually all the member nations want to produce critical equipment rather than concentrating production with those companies and countries which enjoy a comparative advantage. For instance, digital telephone switches were produced by ten companies in western Europe (compared to two in Japan, and three in the U.S.). Consequently, these companies can only sell their equipment in their home markets rather than the entire European market. The EEC has also contributed to the creation of several cartels which increase costs and limit competition. The airline cartel is a case in point.

Europe's preference for large, established companies is also a disadvantage. Because of it, the small entrepreneurial firms, those which generate the largest source of new jobs in the United States and Japan, get little en-

couragement in western Europe. Instead, virtually every European economy is strapped with decaying smokestack industries that must be heavily subsidized. In attempting to break this pattern, Great Britain has taken major steps in the privatization of nationalized industries. Sixteen companies were denationalized between 1979 and 1984 in industries ranging from oil (British Petroleum), to sugar (British Sugar Corporation), to cars (Jaguar), to telecommunications (British Telecom). With the exception of oil, all the denationalized industries have outperformed the market in terms of price per share.

The High-Tech Gap

Another major concern is Europe's inability to compete with the U.S. and Japan in high technology industries, in particular, the poor performance of the European information industries. The European computer market, for instance, is still dominated by IBM. Only this month have the six European computer makers announced that they have adopted a common operating system, the first step towards standardization of European information technology. American companies also dominate the software end of the business, accounting for 87 percent of the personal computer software market in France, for instance.

The weakness of the European nations in the information field is a symptom of a more far-reaching ailment; namely, the lack of an economic environment geared towards innovation. The roadblocks faced in this area apply to the entire European economy as well as the information industries. Innovative European firms labor under sometimes insurmountable burdens—the uncommon common market being the prime example. Far from being an integrated market, the European community places crippling burdens on the development of new products and technology. Testing and certification requirements, differing standards, and border delays all take their toll, adding as much as 20 percent to the cost of intracommunity trade.

But rather than creating the type of unfettered business environment that would foster the development of Europe's still infant venture capital market which the high-tech firms require, the EEC is instead going in the direction of more government spending. The lack of an established venture capital market is a major problem for the high-tech industries. While America's venture capitalists provide an efficient mechanism for launching small firms, Europeans rely on the use of government subsidies instead of market-based capital to finance small firms.

The recent creation of the European Strategic Program for Research in Information Technology (ESPRIT), is a case in point. If anything, this seems a recipe for disaster. It runs the risk of becoming another Airbus, with taxpayers in all member countries contributing many billions of dollars in the support of an enterprise that would best be accomplished in the private sector. The technology and information industries do not need greater government

spending, but the removal of existing barriers, as for instance, the fact that university degrees are not necessarily valid from one country to another.

Government spending, far from an advantage, can sometimes turn into a hindrance, because it usually favors the domestic producer, instead of the most efficient EEC producer, as well as the big, established firms. For instance, some 80 percent of the British government's support of microelectronics has gone to five firms, with half of the total going to one firm alone. Consequently, this system denies the small entrepreneur the necessary access to funds. The dominance of large, established institutions is apparent in most of the European economy's leading sectors. The West German financial sector, for instance, is dominated by the six largest banks. These institutional arrangements discourage the emergence of risk-taking small entrepreneurs.

High-tech industries in the U.S. benefit from close relationships with universities; in fact, about seven percent of American university research is financed by industry. This is not the case in western Europe where universities are unable to compete for quality researchers. The problem arises from the fact that the salaries and resources available to the potential researcher have to be in line with that of other professors in the lock-step promotional system of many European universities. In such a position, it is difficult to woo new talent, and western Europe has been suffering a continuing brain drain.

Forging a tighter link between Europe's excellent research facilities and its industries is an urgent need, but one that is apparently difficult to fulfill. Again and again in the past few years, other countries have successfully brought products to market which were based on European-developed technology. Two Japanese auto firms are already testing cars with ceramic engines, although the West Germans are the acknowledged world leaders in ceramics research. Recently, the EEC placed heavy import duties on laser-operated high fidelity disc players to protect the domestic producers. It is ironic that they would need to protect this industry from import competition since the technology for the development of these disc players was pioneered by Philips in the Netherlands.

Western Europe, the Dollar and Capital Flows

It is impossible to discuss current conditions and prospects for the western European economies without touching upon the impact that the value of the dollar is having on these nations. By now, most everyone agrees that the main factor behind the dollar's appreciation is the strength of the U.S. economy vis-a-vis other major economies. Even Prime Minister Thatcher has offered this explanation for the dollar's strength. The past year has shown, conclusively we believe, that relatively high real interest rates in the U.S. are not the mainstay of the dollar (see last month's ECONOMIC OUTLOOK).

Nevertheless, Europeans, by and large, continue to

complain vociferously about the negative impact of the strong dollar on their domestic economies. The argument goes as follows: A large U.S. federal government deficit results in high real rates of interest in the U.S. (never mind that this link has yet to be conclusively proven). Further, high rates of return for dollar denominated assets siphon investment capital away from the local economies to the U.S. And finally, in an effort to maintain the value of their currencies, the European nations need to raise domestic interest rates, thus dampening the recovery in their investment sectors.

As has been the case with many other truths which floated around during the past couple of years, the fact that the strong dollar is siphoning capital away from European investment does not stand up to scrutiny. While it is true that net foreign assets in the U.S. have risen strongly, the evidence shows that this increase is largely due to a decline in U.S. assets abroad rather than a massive influx of foreign funds into the U.S. Table 3 shows that foreign net capital flows have remained fairly stable since 1981. U.S. assets abroad, however, have declined dramatically. Furthermore, the table shows that the decline in U.S. assets abroad is largely due to a fall-off in private asset holdings, in particular, direct investment. The surge in U.S. investment during the current recovery was not, as some would have us believe, financed by an influx of foreign money, but rather by domestic investors who turned away from foreign capital markets in favor of U.S. capital markets. The implication is clear. The strength of the dollar may very well be the result of a decrease in U.S. demand for foreign currencies rather than an increase in foreign demand for dollars.

TABLE 3
U.S. CAPITAL FLOWS
(billions of dollars)

	1981	1982	1983	I	1984 II	III
Changes in U.S. assets abroad (net capital outflow)	111.0	118.9	49.5	2.0	19.0	(16.0)
Gov't & Official reserve assets	10.3	11.1	6.2	2.7	1.8	2.3
Private assets	100.7	107.8	43.3	(.7)	17.2	(18.3)
Changes in Foreign assets in the U.S. (net capital inflow)	81.3	95.2	81.7	15.7	40.4	6.2
U.S. Treasury securities	8.0	12.8	8.7	1.4	6.5	5.2

¹Negative values (in parenthesis) indicate a net inflow (disinvestment).

Source: *International Economic Conditions*, Federal Reserve Bank of St. Louis, August 1984 and January 1985. *U.S. International Transactions, Survey of Current Business*, December 1984.

Unfortunately, the line of reasoning that goes from the U.S. budget deficit to Europe's current economic woes via the strength of the dollar leads to policy prescriptions that would stymie the global recovery. Namely, that the U.S. must reduce the size of its federal budget deficit so that domestic interest rates, and thus, the value of the dollar, can decline. The argument misses the major factor behind the dollar's strength, that is, the prospect for sustained, noninflationary growth of the U.S. economy. Indeed, a reduction in the size of the U.S. deficit might well be interpreted as enhancing those long-run prospects, thereby making the United States an even more attractive place to invest, and pushing the dollar to new heights.

Conclusion

What is really going on here is that the European nations have been unable to revive their economies. Further, in some cases, they have been unable to benefit from the depreciation of their currencies because of relatively high labor costs (as detailed above in the case of Great Britain). The only long-run option available is the revival of the western European economies. That can only be accomplished by removing the roadblocks to strong economic growth mentioned in this report.

This includes restructuring labor and bankruptcy laws (as detailed above), which raise costs of production and place Europe at a competitive disadvantage with the rest of the world. Secondly, the tax burden in Europe is too high. The tax burden in the European members of the OECD has risen from 32.7 percent in 1962 to 45.7 percent in 1982, compared to a five percentage point increase in the U.S. At the same time, real GNP growth has fallen from an average of 4.5 percent in 1964-1974 to 1.8 percent between 1974 and 1982 (see *International Perspectives on Tax Policy and Economic Growth*, ECONOMIC OUTLOOK, October, 1984). Finally, western Europe needs to devote more of its resources to promoting entrepreneurship and its high technology industries, or risk never being able to catch up with the U.S. and Japan in this area.

EAST ASIA ON THE MOVE

by
Rajni Bonnie Ohri

Recently, the countries of East Asia have been reaping the benefits of the current economic expansion in the U.S. A look at the growth rates of eight nations in that region (Taiwan, Singapore, Hong Kong, South Korea, Indonesia, Malaysia, Thailand, and the Philippines) shows seven of them booming with only the troubled Philippine economy lagging behind. In table 1, the top four countries, the newly industrialized countries (NICs), lead the

region in growth: Singapore, Hong Kong, Taiwan and South Korea. These countries depend heavily on exports of manufactured goods, and over the past year, their exports to the U.S. have soared. In addition to their domestic and regional markets, these countries also have strong trade ties with many other nations, notably Japan.

TABLE 1
EAST ASIA'S REAL GDP GROWTH
(percentage increase)

	1983	1984*	1985*
Singapore	7.9	9.0	7.6
Hong Kong	5.2	8.3	6.5
Taiwan	7.2	10.2	7.4
South Korea	9.3	8.3	7.2
Indonesia	5.0	4.7	5.1
Thailand	5.8	5.9	6.0
Malaysia	5.8	6.4	5.9
Philippines	1.3	-4.2	0.7

*Estimate
Source: International Monetary Fund, Chemical Bank, Citibank

East Asia's economic record stands distinctly apart from other developing regions where accelerating inflation, huge debts, and economic stagnation dominate events. Free market nations in the region boast sustained economic expansion, with living standards on the rise and bright prospects for the rest of the decade. Even troubled Hong Kong—depressed by the prospect of China's taking control from Britain in 1997—has factories running full blast and exports booming. Only in the Philippines do things march backward, with national income unlikely to rise this year. But the progress in the other nations is astounding. Measured in per capita terms, Singapore, for example, is now wealthier than Ireland and is gaining fast on Italy. Taiwan, a nation of 19 million people, exports more than Spain, a nation of nearly 40 million. Tiny Hong Kong, destitute at the end of World War II, now has more Rolls Royces per capita than any other country.

And the boom continues. While West Germany moves to reduce its workweek to 38.5 hours, Hong Kong works Saturdays. While France's President Mitterrand toured the Silicon Valley last year and pronounced himself a venture-capital convert, Taiwan's low-tax, high-tech industrial park near Taipei was entering its sixth year. While most of Europe will be lucky to record three percent growth for last year, South Korea expects eight percent or better.

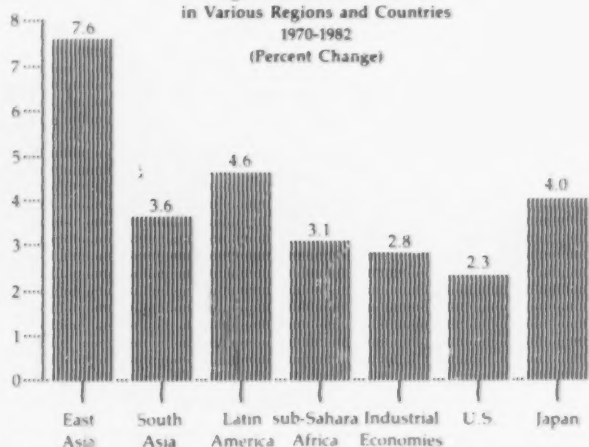
The Asian Advantage

In contrast with the stagnation that plagues America's traditional partners in Western Europe, dynamic growth

is the hallmark of most of the countries in this sweeping Pacific arc. East Asian nations, which not long ago were counted among the most backward, are emerging as dramatically expanding markets as well as tough competitors for the U.S., Japan and Europe.

The implementation of growth-enhancing development policies has been the reason behind this region's success. These nations are proving that private enterprise and free market forces determine the best use of resources and that national development depends on entrepreneurial vigor and economic incentives. Over the past decade, the average compounded growth rate in these countries has been nearly eight percent—roughly three times that of the nations of the European Community and almost twice that achieved by all developing countries (see chart 1). For the group as a whole, GDP (gross domestic product) growth declined to less than five percent per annum during 1980-83, still a respectable performance compared to the rest of the world. In overcoming the obstacles of economic growth, these countries followed an approach that can be broken down into five key elements.

CHART 1
Average Annual Growth of GDP
in Various Regions and Countries
1970-1982
(Percent Change)



First, in contrast to common notions about development, the East Asian countries have financed much of their growth with domestic saving and investment. Neither developing nor developed economies can grow over the long term solely on the basis of savings borrowed from abroad. Adequate incentives for domestic production, saving and investment are at the heart of effective policies for sustained growth. The East Asian countries have provided these incentives and generated impressive savings rates.

In 1981, according to World Bank figures, Americans saved about 18 percent of their GDP. In contrast, the Thais saved over 20 percent of their GDP; the Malaysians from 20 percent to 26 percent; and the Singaporeans from 28 percent to 33 percent. The most dramatic increase in

domestic savings rates has been in Korea (from 1 to 22 percent between 1960 and 1982) and in Indonesia (8 to 23 percent during the same period). In 1981, these domestic savings financed over 80 percent of gross domestic investment for each of the East Asian nations.

Second, the East Asian countries have used foreign assistance to supplement their domestic saving. Aid wisely used as it has been in this region can be a helpful boost to domestic saving. Past U.S. aid, to Taiwan and Singapore, for example, helped create the infrastructure which made economic growth possible. The economic and political stability of these countries has also provided the incentive for investors to keep funds within the region.

Third, the region has generally welcomed foreign investment. Such investment brings with it wider markets and transfers of technology. Foreign investment has been an important source of information on new products, designs and production processes. It also earns its own return rather than creating a fixed debt-service obligation. Currently, the Philippines has a temporary window open to 40 percent foreign equity, and Singapore and Hong Kong have virtually no restrictions on investment. However, Malaysia, for social reasons, has investment requirements that favor its indigenous population, but otherwise maintains an open door to foreign investment. In contrast, investment in Indonesia can be a challenge to foreign firms wanting more than 49 percent equity. Indonesia requires, among other things, that upward of 20 percent of the employees of foreign invested firms be ethnic Indonesians.

The fourth element in the East Asian "high road" to development is its reliance on trade as the engine of development. These countries have developed their export industries efficiently under healthy competition from imports. Exports account for over 45 percent of the combined GNP of these nations. The outstanding success of Korea in exporting manufactured goods is well recognized. But exports of manufactured goods from the Philippines, Malaysia and Thailand have also risen at rates averaging 20 to 30 percent per annum for a decade. Even in Malaysia, where exports of petroleum, timber, rubber, and palm oil have risen dramatically, manufactured exports have accounted for about 35 percent of incremental export earnings over the past decade. Fortunately, manufactured exports from these East Asian countries have held up relatively well during the recent recession, expanding at an average annual rate of 13 percent during 1980-83, compared with five percent for developing countries as a whole.

Although some East Asian countries have erected trade barriers to imports, they have been less restrictive than other developing countries. These nations have relied on liberal trade as the primary engine of development. In contrast, Latin American countries have concentrated on import substitution behind high tariff walls.

Thailand, which protects infant industries, has tariffs in the 30 to 60 percent range. The Indonesian government, in an effort to capture technology and increase employment, requires that trade be conducted through licensed importers, and has designated 120 products that can be imported only through state-owned trading companies. The Korean government also has placed restrictions on some 83 percent of the products it imports and in general, bans certain goods completely, such as foreign cigarettes. These various protectionist barriers are a blot on the region's otherwise good record of liberal trade.

Fifth, the East Asian countries in recent years have adhered to prudent monetary and fiscal policies. These policies have resulted in generally well-structured debt and manageable debt-service payments as a proportion of foreign exchange earnings. Singapore's record in this respect is exceptional: its long-term and medium-term debt-service ratios are under one percent of exports and short-term public debt is essentially private, self-liquidating trade paper. With the exception of the Philippines, other nations in the region have also done well. Indonesia, for example, has a debt-service ratio of about 22 percent and Thailand's is 15 percent; this compares favorably to the debt ratios of some Latin American countries which are close to double these figures (35 percent for Brazil and 30 percent for Argentina).

In sum, the region's road to growth is based on an "open up" rather than a "close out" philosophy. The exports of these countries have surged primarily through trade with the rest of the world, not with each other. The outward looking, market-oriented economies of the region have become models of development. In addition, although there has been government intervention in the private markets, it has worked with the market in a supportive manner. Their remarkable success is persuasive evidence that private enterprise and market forces, not state ownership, is the best engine of rapid economic growth.

U.S. Stake in East Asia

Predictably, the competitive threat from the East Asian countries has drawn a sharp backlash from some of the developed nations. In 1983, U.S. trade with the East Asian region reached \$136 billion—exceeding by \$26 billion bilateral trade with Europe. U.S. exports to the East Asian region have grown 1200 percent since 1960, surpassing by far the growth of U.S. trade with other areas of the world. East Asia has supplanted Western Europe as the number one foreign market for U.S. agricultural exports, accounting for nearly one third of total sales. The major U.S. exports to the region include grain, lumber, chemicals and civilian aircraft. Of America's 20 largest overseas customers, eight are in the East Asian region.

In its bilateral trade with the region, the U.S. sells more than it buys in only one broad category of goods: food, feeds and beverages. And, it's not surprising that, in

agricultural goods, the U.S. has an edge, in view of the high ratio of population to arable land in this country. But in every other category, East Asia comes out ahead. These countries not only dominate the consumer goods sector but also run bilateral trade surpluses in industrial supplies, autos and capital goods. It might be expected that in capital goods production, which is usually a capital-intensive operation, the U.S. would hold a substantial edge over a region where labor is abundant and capital is scarce. But it appears that, on the whole, the region buys most of its capital equipment from Japan, which enjoys a competitive price advantage over the U.S. In total bilateral trade with the region over the first eight months of 1984, Japan had a surplus of \$2.5 billion while the U.S. ran a deficit of nearly \$17 billion.

Taiwan's exports comprise over half of its GNP, 40 percent of which (about a quarter of its GNP) were destined for the U.S. market in 1984. Last year U.S. imports from Taiwan mainly consisted of electronic goods and textiles. The biggest surge has come in sales of computer accessories, including terminals, disk drives and printers. In Hong Kong, leading exports to the U.S. consist of consumer products such as toys, clothing and watches. Singapore's exports to the U.S. rose 52 percent in the first eight months of 1984, consisting mainly of garments and electrical machinery. As a rule of thumb, it appears that every one percent increase of U.S. national income generates about a six percent rise of total NIC exports to the U.S. The recent strength of the U.S. economy is one reason why exports to the U.S. from this region rose so sharply in the first eight months of 1984. As table 2 shows, there has been no comparable rise in U.S. exports to the entire region.

TABLE 2
EAST ASIAN TRADE WITH U.S.
(annual rate of change, percent*)

	Exports to U.S.	Exports from U.S.
Taiwan	44.4	15.6
Singapore	52.2	-10.6
Hong Kong	32.3	18.4
South Korea	39.5	4.0
Malaysia	41.2	16.0
Thailand	44.6	23.2
Indonesia	13.6	-16.1
Philippines	27.3	-0.9

*First eight months of 1984 compared with same period of 1983
Source: Citicorp

In Malaysia, Thailand and Indonesia, real growth was also high this year, but not as high as in the NICs. In these countries, production for export does not represent so large a share of total output, so the growth of their exports to the U.S. has not given them such a powerful boost. What's more, they export chiefly primary commodities, whose performance has been mixed this year.

Falling oil prices have cut Indonesia's earnings. The primary Philippine exports are sugar, coconut products and copper concentrates, while Thailand's include rice, rubber, tin and maize. All of these are subject to world price fluctuations. For the region as a whole, there have been large gains in sales to the U.S. of consumer goods—electronic and electrical appliances, apparel, toys and other labor-intensive products—reflecting the prevalence of relatively low labor costs.

Sustaining Open Trade

The burgeoning trade relations between the U.S. and East Asia are under attack from protectionists in the developed and less developed countries. The rapid escalation of trade flows inevitably creates frictions as foreign competition pressures less competitive producers to meet the overseas challenge. The debate over U.S.-Asian trade in this area centers around the question of relative market access. Many critics claim that East Asian markets are largely closed to U.S. goods because of high tariffs, tax policies, restrictions on investment, regulatory practices, quotas and other barriers. Consequently, these critics advocate that the U.S. retaliate by closing its markets or by implementing more restrictive trade laws.

East Asian barriers and alleged unfair trade practices which are most often cited include: subsidies (government offering cheap capital to uncompetitive industries) as seen in the Philippines (steel and mining) and Malaysia (services and autos); nationalization (common government run sectors include steel, airlines, shipbuilding) as seen in Korea and Taiwan; dumping goods in the U.S. below production costs (alleged violations by the Koreans in T.V.s and footwear); performance requirements (restrictions placed on foreign investment that require that a fixed amount of output be exported) as done in Indonesia and the Philippines; intellectual property violations (pirating and counterfeiting) as evident in the Hong Kong garment industry; and other market distortions, as seen in Indonesia where foreign firms who sell to the government have to take payment in Indonesian exports.

Although the evidence does show that East Asian markets are highly restrictive, there has been a recent trend in the region toward opening up to foreign competition. As mentioned before, while liberal trade has been the engine of growth in East Asia, the region has not been without its share of protectionist barriers. East Asia has begun serious multilateral negotiations to expand trade relations with the U.S. and remove import restrictions on several U.S. products. Mr. Brock, the U.S. trade representative, has warned the East Asian nations that protectionist pressures in the U.S. would increase this year. He has been trying to interest the NICs in negotiations with the industrial countries to liberalize trade barriers on all sides. Last year, the Korean government began a broad overhaul of its tariff rate structure; the government announced its target of having 95 percent of all goods ful-

ly liberalized by 1988. Indonesia, Malaysia, the Philippines, Singapore, and Thailand have agreed to a 25 percent across the board cut in present tariffs on items with import values of above \$10 million as well as other measures to stimulate trade in the region.

The great benefits the U.S. has clearly gained from our booming commerce with East Asia is increasingly obscured by claims that Asian competition is destroying U.S. jobs and jeopardizing our economic future. Our huge trade deficit and the rapid penetration of lower cost Asian goods into our markets has made Asian nations a target of protectionism. Over the past few years, the East Asian countries, Korea and Taiwan in particular, have become formidable new rivals, not only in steel but also in autos, textiles, shipbuilding, machine tools, construction, and more recently, electronics—basic industries that were once the industrialized countries' domain. And, now the NICs have been trying to make the jump out of labor-intensive industries such as textiles, footwear, and simple electronic gadgets, into higher technology industries.

Yet, much of this Asian challenge is healthy: it provides low-priced, quality imports for U.S. consumers (which helps restrain domestic inflation), and markets for our exports. For example, since 1978, General Electric has doubled its trade with the region, with exports and imports totaling \$2 billion in 1983. In addition, operating through joint ventures with local concerns, AT&T is going after a share of the \$16 billion telecommunication industry in the region this year. American investment is also rising much faster in East Asia than in any other region. In the past five years, it jumped by nearly 65 percent, against a global rise of 39 percent. And at the end of 1984, U.S. direct investment in these countries stood at more than \$30 billion.

In addition, the extraordinary economic growth of the region has spawned political stability and market-oriented approaches compatible with U.S. foreign policy goals. The high growth rates in East Asia portend even greater promise for U.S. exports and more jobs for U.S. workers. Indeed, 1.3 million jobs are related to U.S. exports to East Asia. Only with the preservation and expansion of an open trading system can the great benefits of East Asian trade continue, a trade now growing at about 20 percent annually.

Conclusion

Explaining the East Asian economic miracle has recently become a popular topic of discussion. Some attribute it to East Asia's inherited Confucian values; a respect for authority that creates stable politics; a willingness to save and work hard for the sake of children and posterity; or some vague undefined consensus between government and business. However, the real East Asian edge has to be that its prosperous nations have pursued economic policies that emphasize free markets and private enter-

prise. Developing countries tend to be short of capital, so the Asian nations sought foreign investment and treated it well. As a result, they had to borrow less and (apart from the special case of the Philippines) avoided the debt woes of Latin America. Their wages were low, so they aimed low-cost products at consumers in high-wage countries; now Asian-made products fill Western stores, and Asian exporters are some of the most competitive anywhere. And, in addition they keep their taxes low enough to give local entrepreneurs the incentive to grow. However, this is not to imply that every country in the region has embraced the market so closely or as successfully as for example, Taiwan and Singapore. In addition, the region's political development lags behind its economic progress. External threats (from Vietnam or the Soviet Union) or internal dissension (as in the Philippines) could suspend their economic progress.

The Korean language has a slang phrase for goodbye that Koreans use as much as Americans use the phrase, "take it easy." The Korean version, however, translates as "work hard." That seems an appropriate phrase for most of the East Asian countries in the next few years. They will probably have to work harder to achieve less remarkable results than before. High exposure to international trade makes the region more vulnerable than most countries to serious disturbances elsewhere in the world. But so long as the world continues to reward productivity and hard work, East Asia is likely to continue as a world center of prosperity and high economic performance.

TRENDS IN COMMERCE NOTES ON TABLE II

by
Martin Lefkowitz
March 1985

Gross National Product (GNP)—The Department of Commerce revised estimate for economic activity in the fourth quarter of 1984 indicates that GNP—the value of the nation's output of goods and services—grew at an inflation-adjusted 4.9 percent annual rate, a significant upward revision from the earlier estimate of 3.9 percent growth and almost double the increase of 2.8 percent reported in the December flash forecast. Business fixed investment was up 19.7 percent for all of 1984, the best performance in recent economic history. The revised data for the fourth quarter indicated a significant slow down in investment spending to 6.3 percent from 13.7 percent in the third quarter and over 20 percent in the first half of the year.

Money Supply—The nation's money supply—as measured by M-1, currency in circulation plus demand deposits—increased by 0.8 percent in January. This re-

sulted in a 10.6 percent increase (seasonally adjusted annual rate) in the money supply in the latest three month period. This performance places the nation's money supply up 5.9 percent from a year ago. The Federal Reserve's revised money supply data revealed that money supply growth in the fourth quarter did not slow down as much as the initial data had indicated. The revised data increased the annual rate of growth in the fourth quarter from two percent to 3.4 percent.

Employment—Civilian employment—as measured by the monthly survey of households—increased by 118,000 persons (seasonally adjusted), in January to 106.4 million, bringing the employment increase in the last twelve months to three million. The unemployment rate increased 0.2 percentage points in January following a 0.1 percentage point increase in December. The number of nonagricultural payroll jobs—as measured by the monthly survey of business establishments—increased by 350,000 in January. Three-fourths of the increase was in the service sector. The bulk of the increase in the goods producing sector was due to a rise in construction employment.

Prices—The Consumer Price Index for all urban consumers (CPI-U) increased 0.2 percent in January, following a revised 0.3 percent increase in December. This reflects an across-the-board moderation in prices. Gasoline prices declined 1.4 percent in January and are now 15.2 percent below their March 1982 level, when prices were decontrolled. Food prices rose only 0.2 percent in March despite a 3.2 percent increase in fresh fruit and vegetable prices.

Wholesale prices of finished goods remained unchanged in January following a 0.2 percent increase in November. The January standstill in the price of finished goods can be attributed to a 2.4 percent decline in energy prices and a 0.6 percent decline in the price of consumer foods. The declines in energy and food prices were partially offset by increases in motor vehicles, food products machines, construction machinery and other capital equipment. Prices at the wholesale level have increased in two of the last six months, but they remain only 0.3 percent above their level of six months ago for this index. The wholesale price index for finished goods in January was 1.1 percent higher than its year-ago level.

The more volatile part of the Producer Price Index, crude goods, declined 2.2 percent in January. Crude material prices were an astounding 4.2 percent below their level of a year ago. Weak crude material prices appear to be a product of the strength of the dollar in international markets, which is driving down U.S. imports prices; and a glut of farm products, which is holding down crude food and feed product prices at the raw material level.

Housing Starts—Privately-owned housing units were started at an annual rate of 1,833,000 in January, 15 percent above the revised December rate of 1,595,000, but five percent below the number of starts a year ago. This

gain was the result of an increase in apartment building construction. The seasonally adjusted annual rate in January for building starts with five or more units was 692,000, a 76 percent increase from the December rate of 393,000. The January rate of new starts for single family homes was 1,041,000, down four percent from December. Building permits issued in January were up two percent from December. This was the third consecutive rise in the number of permits issued, indicating that housing starts should continue to increase in the months ahead.

Industrial Production—Industrial production increased 0.4 percent in January following a 0.5 percent surge in December. This was the largest increase since July. Industrial output in January was 5.1 percent above the level recorded a year ago. Increases in production occurred in all major groupings of the index for the second consecutive month, with the strongest gains reported in automotive products, defense equipment and energy materials. Business equipment production rose 0.3 percent in January, following a 1.3 percent gain in December. This placed business equipment production at 12.1 percent above the level of a year ago, more than double the increase in production for the entire index.

The capacity utilization rate for manufacturing remained unchanged in January as factories operated at 82.1 percent of capacity, despite an increase in output in the manufacturing sector. Although this utilization rate is below the level of mid-1984, output has still increased because of a continued rise in available capacity and a high level of investment.

Business Costs and Productivity—The productivity numbers for 1984, released at the end of January, appear to give mixed signals. Total business productivity showed a gain of 3.6 percent, the largest single year gain since 1971. Manufacturing productivity rose by 4.7 percent last year, the best performance since 1973. For the fourth quarter of 1984, productivity was up 2.6 percent for all business and 1.7 percent for nonfarm business. However, the manufacturing sector registered relatively a large decline of 0.6 percent. This was the result of a decline of 1.6 percent in durable goods manufacturing productivity which offset a 0.9 percent rise in productivity in the nondurables sector. The decline in durable goods productivity came about as hours worked increased at a faster rate than output. However, this may be related to a data problem in the productivity numbers since the numbers for the fourth quarter of 1983 also indicated a decline in productivity following a very strong increase in the third quarter. In the fourth quarter of 1983, durable goods productivity declined 1.2 percent following a 10.2 percent increase in the third quarter. This is similar to the 1984 pattern which indicates a 1.6 percent decline following a 7.9 percent increase in the third quarter.

For the first time since 1971-72, the U.S. has enjoyed two consecutive years in which the productivity of the nonfarm business sector has increased by over three percent. What is most significant about these numbers is that

this follows a period of five years (1977-1982) when the gain in nonfarm business productivity was nil.

It has been said that the current recovery in productivity is cyclical in nature, and that the recovery in productivity is similar to past recovery experience. The fact is that, in the first eight quarters of the current recovery, productivity in the nonfarm business sector grew by 6.2 percent. This is lower than the 7.3 percent increase in productivity for the same point in the recovery for the previous six recoveries which lasted as long. While the cyclical pattern is indeed true, and we tend to have greater increases in productivity in the initial phase of the recovery, we should not ignore one very important factor. Between 1948 and 1978, there were only two years when nonfarm business productivity did not increase, even in years when economic activity declined, productivity continued to rise. This string was broken in 1979 when we had a period of three out of four years (1979, 1980, 1982) with productivity declines. Further, for the five year period 1977-1982 there was no productivity change on a net basis. It is this reversal in the productivity trend that is one of the most significant aspects of the last two years.

Interest Rates—After a series of rapid declines that resulted in a hasty retreat from 13 percent in early October, the prime rate, now at 10.5 percent, has remained virtually unchanged for nearly two months. Both short- and long-term rates declined in January but are now back up to their December levels. Since last summer, when interest rates peaked, short-term rates have declined more than long-term rates. The federal funds rate, which was 11.47 percent in the week ending June 22, fell 303 basis points to 8.44 percent by February 15. At the same time, the AAA corporate bond rate declined from 13.71 percent at mid-year to 12.02 percent during the week of February 15.

Business Failures and Formations—Dun and Bradstreet's Index of Business Failures indicated that failures increased toward the end of January. The index of business failures, which uses October 1983 as a base of 100, reached 73.7 in the week ending January 25, over 26 percent below the October 1983 level. The number of business discontinuances remained close to the October 1983 level. The latest available data indicates that there were 481,569 new business incorporations in the first nine months of 1984, a 7.4 percent increase over the same nine month period in 1983. After increasing dramatically in the first half of the year, the level of new incorporations has stabilized at the same level as in the second half of 1983. At the current rate, new business incorporations in 1984 will have exceeded 640,000, a significant increase over the 600,400 new corporations of 1983, which was a record year.

Federal Spending—The "Federal Spending Index," a U.S. Chamber devised measure of the monthly change in federal expenditures, indicates that federal spending

decreased one percent in January, but was still 12.9 percent above its year ago level. In the first four months of fiscal year 1985, federal expenditures increased 12.3 percent, about three times as fast as the increase in prices, indicating a real increase in federal spending of about eight percent from the year ago level. Only one-fifth of this increase is the result of rising defense spending. Receipts for January were up 12.9 percent from the same month a year ago due to large increases in personal income and social insurance taxes. Receipts for the first four months of the fiscal year are up 11.6 percent and are rising faster than income. The double-digit rise in federal outlays, despite rather modest inflation and a booming economy, indicates that the deficit problem is the result of uncontrolled federal outlays rather than inadequate tax revenues.

Personal Savings—According to Department of Commerce data, personal savings stood at six percent of after-tax income in the fourth quarter, nearly identical to the third quarter's figure. Personal savings in 1984 were nearly \$40 billion higher than they were in 1983, with the percentage of income saved increasing from five percent in 1983 to 6.1 percent in 1984. This means that sixteen percent of the increase in personal income which occurred during 1984 found its way into savings.

Retail Sales—Retail sales advanced 0.7 percent in January, following a 0.5 percent decline in December. The December decrease was a direct result of declining gasoline prices and weaker automobile sales for the month. The traditional areas of Christmas shopping—department stores, clothing stores and restaurants—all experienced double-digit gains from last Christmas. The January data reflects a reversal of what happened in December: in January, retail stores showed weak sales, but this was offset by a strong automotive sector.

Trade Deficit—The trade deficit, on a goods and services basis, decreased from an annual rate of over \$90.6 billion in the third quarter to \$49.2 billion in the fourth quarter. This improvement is the result of a steep (the equivalent of nearly \$38 billion at an annual rate) drop in merchandise imports, while merchandise exports actually went up slightly despite a continued strong advance in the value of the dollar. The largest decline in imports were in the capital goods area (17 percent); non-fuel industrial supplies also declined (11 percent); and automotive products were down by ten percent. The deteriorating U.S. international trade position is best exhibited by the fact that the deficit for goods and services, which was \$62.5 billion in 1984, was only \$8.3 billion in 1983, following surpluses in 1981 and 1982.

What's Ahead—The composite index of leading indicators, designed to predict future movements in aggregate economic activity, increased 1.7 percent in January, with eight of the 11 available indicators up. This follows a 0.5 percent decline in December. The January increase in the leading indicators series was the largest single month gain in this economic barometer since June 1983.

TABLE II
TRENDS IN COMMERCE

			Previous		Percent Change	
	Current Period	Period	Year Ago	From Previous	Percent Change	From Year Ago
Population (Millions)	Dec/84 237.8	237.6	235.6	0.1		0.9
Gross National Product (\$B) [a]	IV/84 3,764.2	3,694.6	3,431.7	1.9		9.7
Gross National Product (72\$B) [a]	IV/84 1,664.8	1,645.2	1,572.7	1.2		5.9
Money Supply (M1) (\$B) [a]	Jan/85 562.9	558.7	531.4	0.8		5.9
PEOPLE AND THEIR MONEY						
Personal Consumption Expenditures (\$B) [a]	Jan/85 2,429.9	2,416.4	2,288.8	0.6		6.2
Personal Consumption Expenditures (72\$B) [a]	Dec/84 1,084.8	1,074.8	1,037.6	0.9		4.5
Disposable Personal Income (\$B) [a]	Jan/85 2,671.7	2,657.0	2,482.2	0.6		7.6
Disposable Personal Income (72\$) [a]	Dec/84 1,192.8	1,187.7	1,131.3	0.4		5.4
Personal Savings Rate (%)	Dec/84 6.0	6.3	5.2	-0.3[b]		0.8[b]
Civilian Employment (millions) [a]	Jan/85 106.4	106.3	103.3	0.1		3.0
Civilian Unemployment Rate (%) [a]	Jan/85 7.4	7.2	8.0	0.2[b]		-0.6[b]
Average Hourly Earnings [a]	Jan/85 \$8.44	\$8.47	\$8.21	-0.4		2.8
Consumer Price Index (All Urban, 67 = 100)	Jan/85 316.1	315.5	305.1	0.2		3.6
Purchasing Power of the Dollar (1967 = \$1.00)	Jan/85 0.316	0.316	0.327	-0.190		-3.411
Prime Interest Rate (%) February 28, 1985	Jan/85 10.5	10.5	11.0	0.0[b]		-0.5[b]
Retail Sales (\$ [a]	Jan/85 110.7	109.9	106.6	0.7		3.8
BUSINESS PROFITS AND OUTPUT						
Nonfinancial Corporate Profits (\$B)						
Before Tax	IV/84 235.8	224.8	225.5	4.9		4.6
After Tax	IV/84 147.5	141.7	141.1	4.1		4.5
Industrial Production (67 = 100) [a]	Jan/85 166.6	165.9	158.5	0.4		5.1
Capacity Utilization Rate (Mfg.) (%)	Jan/85 82.1	82.1	80.1	0.0[b]		2.0[b]
New Housing Starts (thou. units) [a]	Jan/85 1,833.0	1,595.0	1,933.0	14.9		-5.2
Net Business Formation (67 = 100)	Jan/85 116.5	114.9	115.9	1.4		0.5
New Business Incorporations [a]	Sep/84 51,892	51,723	50,445	0.3		2.9
BUSINESS COSTS						
Unit Labor Costs (nonfarm) (77 = 100) [a]	IV/84 159.8	159.5	157.1	0.2		1.7
Unit Nonlabor Costs (77 = 100) [a]	IV/84 160.8	158.0	151.4	1.8		6.2
Producer Price Indices (67 = 100)						
Crude Materials [a]	Jan/85 322.2	329.3	336.2	-2.2		4.2
Intermediate Goods [a]	Jan/85 320.4	320.6	317.1	-0.1		1.0
Finished Goods [a]	Jan/85 292.4	292.5	289.2	0.0		1.1
FEDERAL SPENDING AND DEBT						
Federal Spending Index (67 = 100) [a]	Jan/85 585.0	590.7	518.1	-1.0		12.9
Federal Government Debt Outstanding (\$B)	Sep/84 1,576.7	1,565.1	1,381.9	0.7		14.1
INTERNATIONAL TRADE						
Exports of Goods & Services (\$B) [a]	IV/84 369.4	368.6	346.1	0.2		6.7
Imports of Goods & Services (\$B) [a]	IV/84 418.5	459.3	375.9	-40.8[b]		42.6[b]
Balance on Goods & Services (\$B) [a]	IV/84 -49.2	-90.6	-29.8	-45.9		64.8
WHAT'S AHEAD?						
Index of Leading Indicators (67 = 100)	Jan/85 166.7	163.9	164.5	1.7		1.3
NOTES: [a] Seasonally adjusted data						
[b] Percentage point difference						

GROWTH OF PER CAPITA PERSONAL INCOME 1978-83

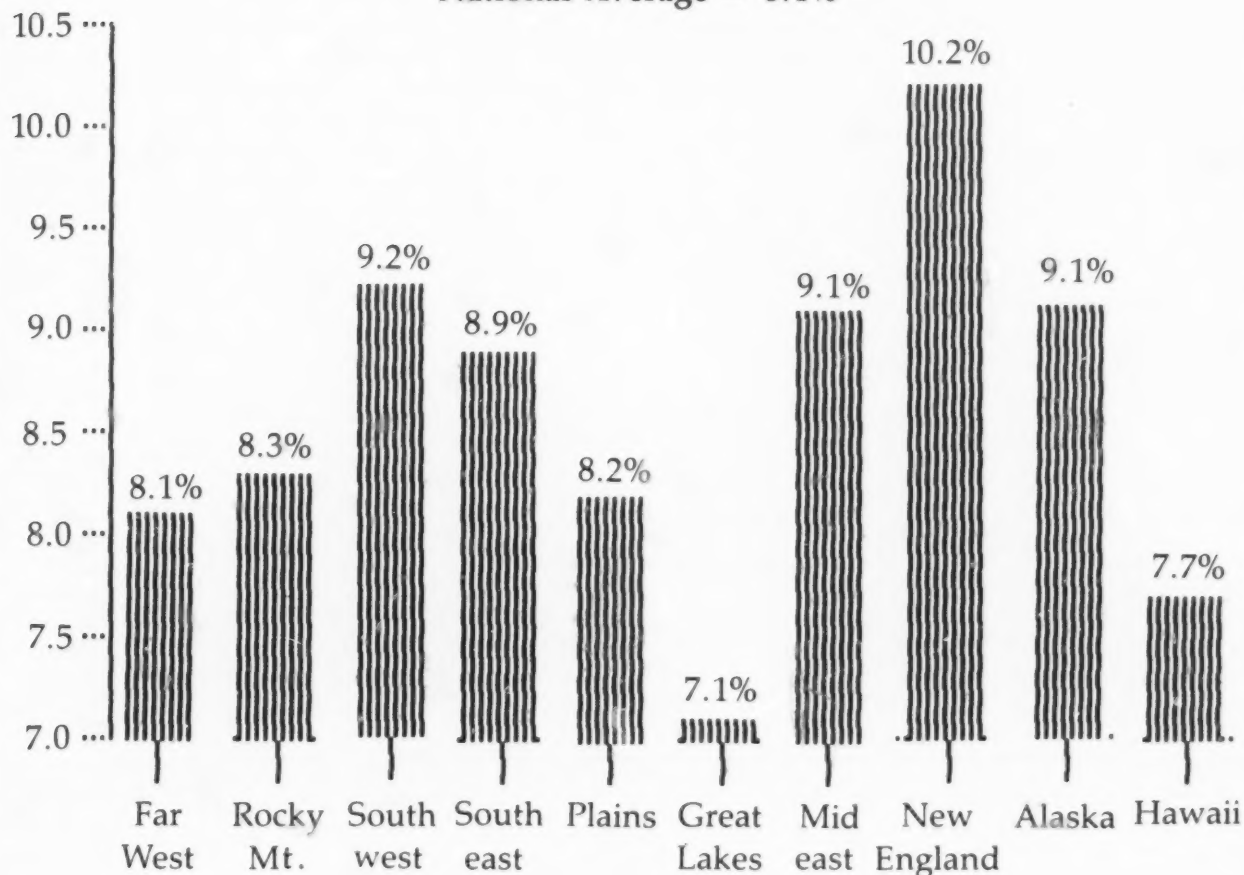
Per capita personal income grew substantially during the past quarter century from an average of just over \$2,000 in 1958 to \$11,658 in 1983. While income levels differ from state to state, and the rate of income growth in the 50 states has also been uneven, certain trends have emerged. The most important is the convergence of incomes, signifying that prosperity in the U.S. is being shared more equally than it was in the past.

Twenty-five years ago, the Far West was the most prosperous region with an average per capita income (\$2,436) that was two-thirds higher than the average lowest income region, the Southwest. In 1983, New England had the highest average income (\$13,005) but the figure was less than one-third higher than the lowest placed Southwest. Another trend is that, on the whole, states with the lowest incomes had the fastest growth over the years. The reasons for this are varied. Industries are more likely to locate in states with lower labor costs, but there are a variety of other considerations, such as union strength and tax rates.

AVERAGE ANNUAL GROWTH RATE OF PER CAPITA PERSONAL INCOME

1978-83

National Average = 8.4%



INTERVENTION IN FOREIGN EXCHANGE MARKETS IS NOT A SOLUTION

In spite of day-to-day swings, the dollar's escalation, which began in early February, has not abated. The chart

shows the dollar's trade-weighted average value for each week since the beginning of 1985. Intervention in foreign exchange markets by the Federal Reserve, the West German Bundesbank, and other European central banks, did nothing to stem the dollar's upward trend. It did, however, cost the central banks involved between \$1 billion and \$1.5 billion.

TRADE-WEIGHTED EXCHANGE VALUE OF THE U.S. DOLLAR

